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Auditors' Choice and Financing Decision of Selected Quoted Firms in Nigeria

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Abstract

This study tested the effect of auditors' choice on financing decision of quoted firms in Nigeria from 2010 to 2014. To successfully carry out this study, the study reviewed various literatures and theoretical issues such as the Modigliani-miller's theorem, and asymmetric of information hypothesis. Secondary data of the big four, size and return on assets were obtained from financial statement of conglomerate listed firms on the Nigeria stock exchange for 5 years. The data were analyzed using linear regression method to achieve the effect of auditor's choice on financing decision. The findings of the study reflect the effect of debit capital which are as follows: an increase on the size of the company (SZ) by 1% would lead to an increase in debit capital (DC) by about 648.7%. The study shows that companies with BIG4 auditors have less debt and more equity in their capital structure and are less likely to issue debt. This study may be developed

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by considering the effect of political and economic institutions on the choice of auditors in Nigeria.

Keywords: Auditors' Choice; External Auditor; Financing Decision; Debt Financing and Equity Financing

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Introduction

Auditing promotes financial stability, re-establishing trust and market confidence for investors and other interested stakeholders. Financial reporting's main goal is to make available useful information for making investment, credit, and similar resource allocation decisions (IASB, 2011). As a consequence, high quality information is a prerequisite for the well-functioning of the capital markets likewise the economy. The users of financial statement can rely on information verified by independent auditors because it confirms the reliability of this information. An audit report is seen as a relevant informational tool for stakeholders (Okere, Ogundana, Adetula, Adesanmi & Lawal, 2017).

Auditing has long been identified as a playing governance role in mitigating the agency concerns in firms. Auditing promotes value creation firm by reducing the incentive problems that arise due to agency problems (Jensen & Meckling, 1976). The financial statements obviously play a critical role in reducing this asymmetry information and their integrity is essential to well-functioning capital markets, (Watts & Zimmerman, 1993). Information asymmetry creates a need for an independent intermediary, the auditor, to verify and provide reasonable assurance of financial accounting reports, prepared by management. The role of the audit therefore, is to fortify trust and uphold confidence in financial reporting. As such, audits help augment economic prosperity, increasing the variety, number and value of transactions that people are prepared to venture into (ICAEW, 2005).

Ever since the corporate collapses (such as the Enron and WorldCom scandals) and High profile cases like Oceanic Bank, Intercontinental Bank, Afribank and Cadbury (Nigeria) which some of their collapse were due to poor management, but many due to fraud, governments across the globe have been looking for ways to avoid similar situations. These corporate disasters and the apparent increase in corporate fraud and unethical business conduct have raised many questions to the functions of auditors and financial reporting. Thus, reducing the level of trust and confidence in these financial reports since the management is accountable for the financial reporting and in addition has a position to exercise will, a risk exists that the information is erroneous, the 'information risk'. Information asymmetry creates a niche for an independent intermediary, the auditor, to verify and provide assurance of financial accounting reports, prepared by management.

The information asymmetry not only exists in the equity capital market, but also causes big difficulties in debt capital markets. This explains the motive why scholars continue searching for the association between audit report and financing decisions as a way to reduce interest expense on corporations. Choosing a Big 4 auditor may lead to more credible financial statements for example, improving the accuracy in firms' earnings (DeAngelo 1981; Balvers, McDonald, and Miller 1998), which in competitive debt markets moderates contracting costs because creditors will not have to resort to spending resources on gathering this information from other sources. The rationale of appointing external auditors is to promote efficient ways of upholding accountability in complex establishments where management interests could be at variance from shareholder interests (Ekumankama & Uche, 2009)

In Nigeria, some studies have examined a differential ways at which audit characteristics affect the performance of firms or the financial decision of firms, but the outcome seems to have been questionable. For instance, studies on the factors affecting audit quality found non audit service as the significant factor affecting audit quality, size of the company and business leverage, (Adeyemi & Fagbemi, 2010) while in industrial economics, degree of corporate complexity and risk are the main determinants of audit quality and fees, (Omar, 2007). However, most studies in Nigeria fail to focus on the relationship between auditor's choice and quoted firms. The theoretical literature brings light to the fact that large auditing firms (Big Four) provide superior auditing services than smaller auditors because they have greater monitoring ability, more valuable reputation to protect and they have "deeper pockets" in case of litigation (Dye, 1993). Consequently, the choice of auditor in determining the financial performance of a firm improves the reputation of such firm amongst competing firms.

To this end, this study aims to determine the effect of auditors' choice on financing decision with respect to long-term debt of selected quoted firms in Nigeria; and also to determine the impact of auditor's choice on equity capital of the selected firms. Therefore, this study attempts to find answers to the following questions:

- i. How does the auditors' choice affect long terms debts of the selected firms?
- i. To what extent does the choice of auditors' impact the equity capital of the selected firms?

Literature review

Auditor's choice

The auditor choice is a decision where company managers need to assess the marginal benefits and marginal costs in hiring a specific auditor. In the literature, the main peculiarity between audit firms used, is the one between high-quality auditors and non-high-quality auditors.

Theoretical framework

The theory upon which the study is founded is the Agency Theory. The Agency Theory is based on the relationship between the principal (owners) and the agent (managers). Theories considered in the study are as follows:

The Modigliani-Miller's Theorem

The Modigliani-Miller's theorem (Modigliani and Miller, 1958) is a theory of capital structure. They assume that a perfect capital market has no transaction or bankruptcy costs, and people receive perfect information. Hence, entities can borrow at the same interest rate devoid of taxes and their investment decisions would not be affected by financing decisions. Based on the assumptions, Modigliani and Miller (1958) state the value of a firm is independent how that it is financed because its value is dependent on the profitability of the firm. Therefore, the firm does not an optimal capital structure. However, the real world reflects that firm's value is relevant with its bankruptcy costs, agency costs, taxes, information asymmetry and so on.

The Trade-off Theory

The trade-off theory of capital structure refers to the idea that a firm decide on how much debt finance and how much equity finance to use through cost-benefit analysis. An important purpose of the theory is to clarify the fact that organizations usually are financed partly with debt and partly with equity.

The Market Timing Theory

This is conveyed up by Baker and Wurgler (2002). They use the market-to-book ratio to size the market timing opportunities observed by managers. Otherwise, they construct a historical market-to-book ratio (external finance weighted-average market-to-book ratio, EFWAMB) to capture firm's past equity market timing attempts. Also present in this theory, there is no optimal capital structure, so market timing financing decisions just accrue over time into the capital structure outcome. However, the market-to-book ratio of equity plays a dual role in empirical studies. It is used as a measure of market mispricing (over or under-pricing) and is utilized as a proxy for future growth opportunities in the trade-off framework. Firms with higher growth opportunities, which typically have higher valuations, may prefer to lower their leverage to maintain their financial flexibility (Myers, 1977). Flannery and Rangan (2006), Kayhan and Titman (2007) disagree with Baker and Wurgler on the persistence of the effect on capital structure. Contrary to Baker and Wurgler (2002), finds that the importance of historical average market-to-book ratios in leverage regressions is not due to past equity market timing.

Agency Cost Theory

It recommends that the optimal capital structure is determined by agency cost, which up shoots from conflict of interest amongst different recipients (Jensen and Mackling, 1976). From a theoretical point of view, an organization may be perceived as a set of

principal-agent relationships more or less ranked in which several agents may also exert their function as principal towards others. Each actor or group of actors will try to act so as to satisfy their own wellbeing. Optimal financial structure is one which allows resolving differences of interest between agents, so as to maximize the total value of the firm. Capital structure may affect the value of a company, acting on how to motivate managers and on the conflicts of interest that may exist between shareholders and creditors, resulting in the probability of bankruptcy and urging shareholders and creditors to supervise the managers and limit the abuse.

Empirical review of literature

DeAngelo (1981) posits that the auditor independence is the joint probability that auditors will find and report misstatements in the financial statements. She argues that the quality of an auditing firm is positively linked with firm size or the firm's market share. Diamond (1989) argues that young firms suffer more severe asset substitution and moral hazard problems. He models the dynamics of borrowers' incentives with lenders learning over time from observing firms' credit records. Lang (1991) provides theory and evidence that the magnitude of stock price reactions to earnings announcements diminish with age, which he interprets as indicating that firm-specific information, is gradually revealed over time.

Becker *et al.*, (1998) states: "auditing reduces information asymmetry that exists between managers and firm stakeholders by allowing outsiders to verify the validity of financial statements." Francis *et al.*, (1999) find that firms with otherwise relatively high uncertainty about reported earnings are induced to hire a Big Six auditor to bolster the credibility of their financial statements. They report evidence that this external monitoring constrains aggressive and potentially opportunistic reporting of accruals-based earnings. Francis and Krishnan (2005) contend that larger auditors provide higher-quality audits in order to protect their own reputations and to avoid costly litigations. Despite some recent high-profile cases (e.g., Arthur Andersen), the collective evidence is strongly supportive that large audit firms can provide higher quality audits and better monitoring (Ireland & Lennox, 2002; Lee *et al.*, 2003; Lennox, 2005; Watkins, Hillison, & Morecroft, 2004).

Willenborg (1999) finds that auditor size is negatively related to IPO underpricing (a setting where information asymmetry is expected to be particularly strong), while Mansi *et al.*, (2004) and Pittman and Fortin (2004) find that larger auditors (proxied by whether they are a Big Six firm or not) are associated with a lower cost of debt for their clients. Lennox (1999) examined the relationship between bankruptcy and auditor switch and the result showed that a switch is a weak signal of financial distress. Maybe one of the reasons that these relationship have not supported was that the samples were small and they did not consider the other factors related to auditor switch. DeFond *et al.*, (2000) reported that the independence of auditing practices in China had been improving, as evidenced by the increasing frequency of the modified opinions (non-standard audit reports) issued by Chinese auditors. DeFond *et al.*, (2000) found that big auditors were more likely to issue the qualified opinions in China. Since audit quality is positively related to the size of auditing firms, we posit that large auditing firms should provide higher-quality auditing services in China.

Similarly, Pittman and Fortman (2002) find evidence consistent with Diamond's prediction that firms lower their interest rates by developing their reputations in debt markets. Dunn and Mayhew (2004) document a positive relationship between audit quality and disclosure quality, measured as firm-wide industry specialization and AIMR disclosure score, respectively. Khurana and Raman (2004) states, that the ability to detect material error in the financial statements is a function of auditor competence while the propensity to correct/reveal the material error is a function of auditor independence from the client. Fan and Wong (2005) document a positive relationship between the Big4 auditor choice and the wedge of vote-cash flow rights in East Asia companies, thus showing how Asian family firms signal their motivations to small investors.

Also, Guedhami, Pittman and Saffar (2007) find strong, robust evidence from panel data estimation that privatized companies globally become less (more) likely to appoint a Big Four auditor with the presence of state (foreign) owners even though expectations are foreign owners will prefer to hire a Big Four auditor to better monitor the newly privatized organizations to inhibit expropriation by controlling insiders and their political backers.

Methodology

This study covers the effect of auditor choice on financing decision of quoted firms in Nigeria. This implies that all aspect of the Big Four auditing firm with respect to suitability in the Nigerian firm is covered in this study. This study evaluates conglomerate firms listed on the Nigeria Stock Exchange (NSE), which includes; A.G. leventis Nig. Plc; Chellarams Plc; John Holt Plc; SCOA Nig. Plc; Transnational Corporation of Nig. Plc; and UACN Plc; for a period of five (5) years from 2010 to 2014. Based on the theoretical framework and the Modigliani-Miller's theorem, this study adopted the linear regression model. Due to our dependent variable (financing decision) combination of real numbers and binary variable, we used regression technique to confirm the relationship between financing decision and independent variables.

$$FD = \beta_0 + \beta_1 AD + \beta_2 SZ + \beta_3 ROA + \varepsilon$$

Where, FD = financing decision which includes real value of debt or real value of equity

AD = auditor choice

SZ = size

ROA= return on assets

It is expected that the choice of auditor, size and deposit asset should have a positive impact on the financing decisions. Symbolically, it is expected that $\alpha > 0$, $\beta > 0$ and $\Theta > 0$. Financing decision: proxies by total value of debt or equity, it is measured by the sum of the market value of equity and the book value of total debt.

Auditor report: proxies by the Big Four which are Akintola Williams Deloitte; Ernst & Young (E & Y); Klynveld, Peat, Marwick and Goerdeler (KPMG) and

PricewaterhouseCoopers (PwC). This is measured by companies that use Big Four will take 1 and 0 for companies not using Big Four auditors.

Size: Proxy by total assets of the firms.

Return on assets: Proxy by the ratio of profit and loss to total assets.

This study made use of secondary data spanning from 2010 to 2014. This study has specified two objectives. The two objectives were analyzed using statistical package for social science (Linear Regression). The secondary data used was collected from financial reports from conglomerate companies listed on NSE from 2010 to 2014. The data collected would be used to analyze the impact of financing decisions on auditor choice and report.

Findings

Analysis of Auditor's Choice and Long-term Debt of Selected Quoted Firms in Nigeria.

Table 1 Effect of Auditor's Choice on Long-term Debt

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|----------------------|-------------|-------------------------|-------------|---------|
| C | -89.987 | 30.895 | -2.913 | 0.007 |
| LOG (SIZE) | 6.487 | 1.938 | 3.347 | 0.002 |
| ROA | -0.113 | 0.061 | -1.858 | 0.074 |
| BIG 4 | -9.823 | 2.732 | -3.596 | 0.001 |
| R-squared | 0.405 | Mean dependent variable | | 8.2817 |
| Adjusted R-squared | 0.337 | S.D. dependent variable | | 7.00021 |
| Durbin-Watson stat | 1.283 | Prob.(F-statistic) | | 0.000 |
| Sum squared residual | 844.967 | F-statistic | | 5.909 |

Dependent Variable: LOG (Debt Capital)

Empirical Analysis of the Impact of Auditor's Choice on Equity Capital of Selected Firms.

Table 2: Impact of auditor's choice on equity capital
 Dependent Variable: LOG (Equity Capital)

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|----------------------|-------------|-------------------------|-------------|---------|
| C | 24.943 | 3.596 | 6.936 | 0.0000 |
| LOG(SZ) | -0.635 | 0.226 | -2.817 | 0.0090 |
| ROA | 0.002 | 0.007 | 0.275 | 0.7850 |
| BIG4 | 1.740 | 0.318 | 5.470 | 0.0000 |
| R-squared | 0.538 | Mean dependent variable | | 8.2817 |
| Adjusted R-squared | 0.485 | S.D. dependent variable | | 0.67782 |
| Sum squared residual | 11.449 | F-statistic | | 10.086 |
| Durbin-Watson stat | 0.929 | Prob. (F-statistic) | | 0.0000 |

Interpretation of result and discussion

Table 1, the R-squared value of (0.405) shows how the variations in Debt Capital (DC) are explained by Size of the company (SZ), Return on assets (ROA) and Auditor choice (BIG4). Thus, this high value of R-squared means that the model has a good fit. The F-Statistic value is highly significant and the explanatory variables are capable of explaining the variation in Debt at 5% level. This implies that the model is statistically significant. The value of the Durbin-Watson stat is (1.283) indicates that there is no auto correlation because it is relatively close to 2, the absence of auto correlation shows that the independent variables are truly independent.

The coefficient of the Size of the company (SZ) is positive (6.487) and significant at five per cent significant level, implying that the company size has positive significant effect on Debt capital and one per cent increase in the size of the company would increase the debt capital by 648.7%. The coefficient of Return of assets (ROA) is positive (-0.113) and significant at five per cent significant level implying that the return on assets has negative significant effect on debit capital and one per cent increase on return on assets would decrease the debit capital by 11.3%. Also the coefficient of Auditor choice (BIG4) is negative (-9.823) and significant at five per cent significant level implying that the auditor choice would decrease the debt capital by 98.23%. This means that there is a significant relationship between the firms audited by Big Four companies and the debt capital.

Table 2, R-squared value of (0.538) shows how the variation in Equity Capital (EC) are explained by Size of the company (SZ), Return on assets (ROA) and Auditor choice (BIG4). Thus, this high value of R-squared that the model has a good fit. The F-Statistic value is high significant and the explanatory variable are capable of explaining the variation in Equity at 5% level. This implies that the model is statistically significant. The value of the Durbin-Watson stat is (0.929) indicates that there is auto correlation because it is not in any way close to 2, the presence of auto correlation shows that the independent variables are truly independent.

The coefficient of the Size of the company (SZ) is negative (-0.635) and insignificant significant level, implying that the company size has a negative significant effect on Equity capital. The coefficient of Return of assets (ROA) is positive (0.002) and insignificant level implying that the return on assets has positive insignificant effect on equity capital. In contrast to the above, the co-efficient of Auditor choice (BIG4) is positive (1.740) and significant at five per cent significant level implying that the auditor choice would increase the equity capital by 174%. This shows that there is significant relationship between the firms audited by Big Four companies and the equity capital.

Conclusions

In this study, Big 4 audit firms are considered to be “high-quality” auditors and consequently they provide a higher perceived and actual audit quality. Big 4 auditors play an essential role in capital market to provide credible financial information to the investors. The auditor’s opinion can, to some extent, influent stock prices and cost of debt

when it conveys information for future cash flows and expectation of firms' viability. The study examines three (3) variables namely: Size (SZ), Return on Assets (ROA), Auditor Choice (BIG4) on financing decision and provides evidence that the difference in information asymmetry associated with higher quality auditors affects companies financing choices. The study shows that companies with BIG4 auditors have less debt in their capital structure and are less likely to issue debt. They financed a smaller portion of their deficit with debt. Secondly, these companies with BIG4 auditors depend less on market conditions for their equity decisions.

Policy recommendations

Based on the research outcomes and conclusions made, the following recommendations are made:

1. Researchers can improve this study by carrying out investigation on the effect of other factors on auditor choice, such as the features of board of directors in Nigeria.
2. This study may be improved upon by including more variables that may affect audit quality
3. The study recommends that more researchers should carry out investigation on indirect effects of auditor choices such as cost of capital and cost of litigation.
4. This study may be improved by analyzing how political and economic institutions affect the choice of auditors in Nigeria.

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